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THE REVENUE ACT OF 1971—DO TAX INCENTIVES HAVE NEW LIFE?

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This article presents a survey of the tax policy decisions implicit in the Revenue Act of 1971.[1] It will focus on the reasons, or the lack of reason, behind the principal legislative decisions of the Act, both for the light such an examination will shed on the decision-making process and the hints it can provide regarding the shape of things to come. The Act invites this examination of the legislative process. After taking a modest plunge into reform waters in the Tax Reform Act of 1969,[2] in 1971 Congress enacted measures which suggest a congressional scrambling back to the more familiar dry ground of tax incentives. It would appear that Congress was convinced that our market economy would not make the correct decisions without the dirigisme of tax signals structured to give the message: "The Government would rather that you do this than this."

The content of the Act can be summarized as follows:

(1) Two major provisions speeded up the timing of tax reductions already scheduled.[3] It may be noted here that this is merely fiscal fine tuning, although fine tuning as such probably reveals a dirigistic bent.

(2) There was an increase in the minimum standard deduction.[4]

(3) The investment credit was restored[5] and a new incentive depreciation system was approved.[6] New tax incentives

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1 Act of Dec. 10, 1971, Pub. L. No. 92-178, 85 Stat. 497 [hereinafter cited as Revenue Act of 1971].

2 Act of Dec. 30, 1969, Pub. L. No. 91-172, 83 Stat. 487.

3 Revenue Act of 1971, § 201 (personal exemption), amending Int. Rev. Code of 1954, § 151; and §§ 202-03 (standard deduction rate and ceiling), amending Int. Rev. Code of 1954, § 141.

4 Revenue Act of 1971, § 203 raises the standard deduction for 1971 to the larger of 13% of adjusted gross income, with a maximum allowable deduction of $1500, or a low income allowance of $1050 ($525 in the case of a married individual filing a joint return); § 202 increases the deduction for 1972 and thereafter to the larger of 15% of adjusted gross income, with a maximum deduction of $2000, or the low income allowance of $1300 ($650 in the case of a married individual filing a joint return). Int. Rev. Code of 1954, § 141(c).

5 Revenue Act of 1971, § 101. The investment credit restored by the 1971 Act applies, with some exceptions, to property constructed or acquired after August 15, 1971. Int. Rev. Code of 1954, §§ 46-48.

6 Revenue Act of 1971, § 109(a) gives the Treasury Department authority to prescribe a class life system of depreciation, which, it is expected, will closely follow the Asset Depreciation Range (ADR) System adopted by the Treasury in June 1971. Int. Rev. Code of 1954, § 167(m).

were adopted for exporting,[7] for campaign contributions,[8] for providing jobs under the work incentive program,[9] and for providing certain on-the-job training and day-care facilities.[10]

(4) An expanded child care deduction was included that could be regarded either as an incentive or an equity measure.[11]

(5) The usual catch-all technical amendments were added, most of which tightened the 1969 loophole closers with regard to alleged technical defects.[12]

I. Some Fiscal Dimensions

An evaluation of the basic spirit of the 1971 Act must start with an analysis of its character as a fiscal policy measure rather than as a tax policy measure. The legislation grew out of the President's August 15 message, which signalled his full conversion to fiscal activism and price-wage control.[13] At that time, the President apparently regarded

[7] Revenue Act of 1971, § 501 created the Domestic International Sales Corporation (DISC), a new tax entity whose business is exporting, and whose profits are not subject to federal income tax. The basic requirement for qualification as a DISC corporation is that 95% or more of the gross receipts of the corporation consist of qualified export receipts (as defined in § 993(a) of the Internal Revenue Code). Profits are taxed to the shareholders of a DISC corporation and not to the corporation itself. Generally, half of the profits are taxed to the shareholders currently. The tax on the other half is deferred until such time as the profits are distributed, the shareholder sells his stock, or the corporation loses its qualification as a DISC corporation. Int. Rev. Code of 1954, §§ 991-97.

[8] Revenue Act of 1971, §§ 701-02, 802. Under the Act, a taxpayer can designate that $1 of his income tax liability ($2 for married persons filing joint returns) is to be set aside in a special account for the use of presidential candidates of the political party of his choice or for use by all presidential candidates. Revenue Act of 1971, § 802 (Int. Rev. Code of 1954, § 6069(a)). In addition he is allowed either an itemized deduction of up to $50 ($100 for joint returns) for his political contributions. Revenue Act of 1971, § 702 (Int. Rev. Code of 1954, § 218). In lieu of such deduction, a tax credit of up to $12.50 ($25 for joint returns) may be claimed. Revenue Act of 1971, § 701 (Int. Rev. Code of 1954, § 41).

[9] Revenue Act of 1971, § 601. The Act grants a taxpayer, subject to certain limitations, a credit against tax for the taxable year in an amount equal to 20% of the "work incentive program expenses" (as defined in Int. Rev. Code of 1954, § 50B(a)) which the taxpayer has paid or incurred during tax years beginning after 1971. Int. Rev. Code of 1954, § 40.

[10] Revenue Act of 1971, § 303. The Act permits a taxpayer to elect, in accordance with regulations to be prescribed by the Commissioner, to amortize over a 60-month period capital expenditures incurred in acquiring, constructing, reconstructing or rehabilitating on-the-job training or child care facilities. Int. Rev. Code of 1954, § 188.

[11] Revenue Act of 1971, § 210. Under the Act, a taxpayer who maintains a household may claim a limited deduction (a maximum of $400 per month) for employment-related expenses incurred in obtaining care for a dependent under the age of 15, a dependent who is physically or mentally disabled or a disabled spouse of the taxpayer. The deduction is an "itemized deduction" and is the same for a single person or a married couple filing jointly. Int. Rev. Code of 1954, § 214.

[12] See, e.g., Revenue Act of 1971, § 310(a), amending Int. Rev. Code of 1954, § 162(c), dealing with illegal bribes and kickbacks.

[13] The President's message of August 15, 1971 is contained in Hearings on the

the bulk of his followers as not yet converted; accordingly the new program was described as a balanced fiscal package with expenditure reductions to offset tax reductions. But, nevertheless, it was billed as a program that would have expansionary employment effects.[14] While there might have been some reasons for a balanced reduction of government taxes and expenditures, such action would do little to stimulate employment.[15] The explanation resolving the apparent incongruity of this program was that the major part of the President's expenditure reduction was to be accomplished by the "postponement" of two major pieces of legislation—revenue sharing and welfare reform—that, as of August 15, 1971, could not possibly have been enacted in timely fashion. On balance, then, the fiscal program *was* expansionary.

Before the size of the fiscal stimulus administered by the Act may be examined, a warning must be issued to users of congressional documents who are not familiar with the intricacies of congressional revenue estimating. A congressional committee report is primarily a political document designed to assist in passage of the bill and to win political support for the committee; only secondarily is it intended to be a source of objective information. With this caveat in mind we may proceed with an analysis of the fiscal policy aspects of the Act.

The revenue estimates issued at the time of the President's statement should be evaluated with reference to the fact that earlier in the year the Treasury Department had announced proposed changes in the depreciation deduction rules (the Asset Depreciation Range (ADR) System) that would have resulted in substantial revenue losses.[16] As of August 15, 1971, it was accepted as fact that the Treasury would issue these rules in final form substantially unchanged from the initial proposal. It was also accepted that the legality of these regulations would be challanged in the courts. However, the depreciation regulations were never issued in final form. Instead, Congress enacted part of them in the 1971 Act.[17] Since the revenue estimates for the 1971 Act were constructed on the assumption that the Treasury regulations would be controlling, the revenue consequences of the depreciation rules that were enacted by Congress were omitted from the revenue estimates. The part of the Treasury's proposed regulations that Congress did not enact—the three-quarter year convention—would have entailed signif-

Revenue Act of 1971 Before the House Ways and Means Comm., 92d Cong., 1st Sess. 2 (1971) [hereinafter cited as 1971 Hearings].

14 Id.

15 For some discussion of the net expansionary effect of the package, see the testimony of Carl Shoup, id. at 1214-18.

16 House Ways and Means Comm., the Revenue Act of 1971, H.R. Rep. No. 92-533, 92d Cong., 1st Sess., reprinted in 2 U.S. Code Cong. & Ad. News 1913 (1971).

17 Revenue Act of 1971, § 109(a) (Int. Rev. Code of 1954, § 167(m)).

icant short-term revenue losses. Accordingly, in its estimates the Committee on Ways and Means reported the effect of its decision not to enact those regulations as a revenue gain because they regarded that action as a tightening of the law presumptively in effect as of August 15, 1971.[18] These inconsistencies are understandable from the viewpoint that committee reports are political documents rather than objective analysis of the facts. Since the Revenue Act provided considerable business tax relief in the investment credit, it was impolitic to brag about giving yet more business tax relief. Hence the Committee claimed that the original tentative depreciation regulation was not theirs but the Administration's.

In any case, the actual revenue effects of the Revenue Act of 1971 in subsequent years are of more significance than the Committee estimates. Table I provides an inclusive statistical picture. It does not, however, give a single answer to the question, "What are the revenue effects?" That question must be qualified by the further question, "Since when?" The Committee's figure of —$1.7 billion (line 12) indicates what it predicted would happen after August 15, 1971, assuming that the Treasury could fight off court challenges to its proposed ADR regulations. Line 15 indicates what the Government actually did in 1971.

TABLE I
REVENUE EFFECT OF TAX CHANGES IN 1971[19]
(calendar year liabilities, billions of dollars)

Committee Basis (Revenue Act of 1971)	1971	1972	1973
1. Speed up of scheduled individual reductions	—1.4	—2.2	
2. Increase in minimum standard deduction		—1.0	—1.1
3. Tightened standard deduction rule for certain dependents		0.1	0.1
4. Child care deduction		—0.1	—0.2
5. Repealing auto excise tax	—0.8	—2.2	—1.9
6. Repealing certain truck taxes	—0.1	—0.4	—0.4
7. Tax credit for political contributions		—0.1	*
8. Investment credit	—1.5	—3.6	—3.9
9. Tax credit for WIN employers		*	*
10. Tax deferral for export profits (DISC)		—0.1	—0.2
11. Eliminating 3/4 year convention from ADR	+2.1	+1.7	+1.5
12. Total Committee Basis* (total lines 1-11)	—1.7	—8.0	—6.0
13. Elimination of "gain" from 3/4 year convention	—2.1	—1.7	—1.5
14. ADR as enacted**	—0.7	—1.4	—2.5
15. Total Government 1971 Actions (line 12 plus lines 13-14)	—4.3	—11.1	—10.0

* Details may not add to total due to rounding and omission of some minor items.

** This contains no allowance for the revenue effect of repealing the reserve ratio test. It also overstates the use of ADR, putting it at 100%. These "errors" tend to be offsetting.

[18] H.R. Rep. No. 92-533, supra note 16, at 1829-30.

[19] 1971 Hearings, supra note 13, at 19; see also Staff of Joint Comm. on Internal

The passage of the Revenue Act of 1971 on December 10 of that year followed by slightly less than four months the President's tax message of August 15. It is noteworthy that Congress was willing to enact promptly the tax reductions for fiscal policy reasons suggested by the President. The long travail of 1967-68 stands as evidence of Congress' great reluctance to move when the fiscal situation calls for a tax increase. Compared to 1969, it might be a matter of satisfaction that the Congress only added a small amount to the President's request.[20] As a fiscal measure enacted to deal with the unemployment problem the bill deserves good marks for the total tax change involved: whether these were the best reductions to enact is another story to which we will return.

II. The Business Incentives

A. *Investment Tax Credit and Accelerated Depreciation (ADR)*

There is no doubt that the most important parts of the Revenue Act of 1971 were the general business incentives provided by the new depreciation rules and the investment tax credit.[21] Yet an examination of the legislative history of the investment tax credit and ADR contains very little evidence that Congress conducted any serious economic or tax analysis of the issues involved.[22] For the most part the Administration's arguments were spurious. The most publicized argument for the investment credit was the theory that it would produce jobs—an argument that gave the provision its ridiculous name, the job development credit. This argument is spurious because virtually any tax cut will produce jobs. Therefore, the only rational reason to prefer a tax reduction related to business investment is that there are policy reasons for increasing the relative numbers of jobs pertaining to the production of machinery and equipment.[23]

Revenue Taxation, 92d Cong., 1st Sess., General Explanation of the Revenue Act of 1971 (1972). Technically, this document is a staff summary, not a formal Committee Report. It is prepared by the same staff that writes Committee Reports for the Committee. It has the conspicuous advantage of including Senate floor action and Conference Committee action, which are otherwise not adequately reported. It also cuts away parts of Committee actions which did not survive final action. Unless there is special need to go back to Committee Reports, this article will cite the General Explanation.

20 There was a complex of additions and subtractions: the additions consisted mainly of the minimum standard deduction and the long-run 7% minimum credit rate; subtractions were the 10% short-run investment credit and the ¾ year depreciation convention.

21 Revenue Act of 1971, §§ 101-09 (Int. Rev. Code of 1954, §§ 46, 48, 167(m)).

22 See H.R. Rep. No. 92-533, supra note 16, at 1832-50; S. Rep. No. 92-437, 92d Cong., 1st Sess. 1931-59 (1971).

23 The irrelevance of the employment issue is treated at length in Brannon, The Effects of Tax Incentives for Business Investment: Survey of the Economic Evidence, in Joint Economic Comm., 92d Cong., 1st Sess., Economics of Federal Subsidy Programs, pt. 3 (Tax Subsidies) (1972).

A second argument supporting the investment tax credit, and one virtually as spurious, was that an investment incentive would improve our "international competitive position" and our balance of payments.[24] Our competitive position and our balance of payments depend ultimately on the relation of our exchange rates to various physical and market facts, such as productivity.[25] In the same message in which the President announced a floating dollar, then, it was slightly incongruous for him to have urged a measure which was designed to increase our competitiveness. A rational reading and interpretation of the President's argument—which, it must be noted, was accepted by the Congress—would have to introduce three additional assumptions:

> (1) that it was expected that the international monetary settlement, which later occurred at the Smithsonian, would be inadequate, *i.e.*, that it would leave the dollar overvalued;
> (2) that international monetary mechanisms would remain as ossified as they have been since the Bretton Woods Agreement and that they would continue to be unable to handle overvaluation of a key currency like the dollar; and
> (3) that the increased productivity associated with more machinery would result in lower prices rather than higher wages.

In retrospect assumption (1) now seems true, although it seems unlikely that it was reasonable to make the assumption in August 1971. Further, assumption (2) now seems quite wrong, since we have devalued further and appear to be very close to a flexible exchange rate system. Although there is little evidence regarding the veracity of assumption (3), most official statements on wage policy seem to accept productivity increases as a basis for wage increases, which means that the same productivity increases are not available to reduce prices. If we were to accept these three assumptions as given, the discussion of benefits and costs of investment credit as an efficient foreign exchange instrument could be approached on a rational economic and tax basis. However, so far as impact on the prices of our exports is concerned, it would appear that DISC is a more direct and effective mechanism than the investment tax credit.[26] Thus the balance of payments argument for an investment tax credit is of doubtful strength.[27]

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[24] Hearings on the Revenue Act of 1971 Before the Senate Finance Comm., 92d Cong., 1st Sess. 6-7 (1971).

[25] If there is a certain state of competition between United States and German producers it can be changed by changing exchange rates, as the United States did in a 10% devaluation in 1973. Literally there is no deterioration in our competitiveness that could not be offset by some set of exchange rates.

[26] See discussion in text at notes 40-53 infra.

[27] For a related analysis see Taubman, Investment Tax Credit—Once More, 14 B.C. Ind. & Com. L. Rev. 871 (1973).

The final argument in support of the investment credit is that it would channel relatively more of our output into capital goods, which would increase future output at the expense of either current consumption or housing.[28] Here again the legislative history reveals very little effort to present issues and evidence to support this conclusion, especially regarding the point that in the long run there are trade-offs between more business capital and more current consumption and housing.

Yet despite the paucity of argument the Administration achieved most of its goals. Although the Administration lost the three-fourth year convention on depreciation,[29] and its proposal to make the investment credit rate 10% for a year[30] (then falling back to 5%) failed, the long-run investment credit rate was put at 7%,[31] which was a very good trade-off for business. There is no evidence that the fine tuning idea of a temporarily high rate of investment credit was carefully thought through, especially regarding the factors of the anticipation of purchases around the announced date for reduction to 5% and the implicit drop in investment thereafter.[32] The Administration probably was quite pleased with the trade-off.

How can one account for such success based on such poor economic and tax analysis? One plausible explanation, and one that gives some clear insights into the legislative decision-making process, is that Congress contains a bloc of pro-business votes as well as a bloc of liberal votes and that an issue such as the investment credit is decided by a relatively small number of swing votes in the center. A second possible explanation is that the Congress probably faces a particularly difficult task in denying a provision that has been endorsed by the Treasury Department. This, as we suggested earlier,[33] apparently explains why there was no serious effort to substitute a telephone tax reduction for an automobile excise tax reduction.

It is submitted that there was in Congress a large group in the center who believed the argument that the federal tax structure, taken as a whole, bears too heavily on investment, and that this bloc of votes swung the decision in favor of the investment credit. According to this

28 Brannon, supra note 23.

29 T.D. 7128, 36 Fed. Reg. 11,924.

30 Id.

31 Int. Rev. Code of 1954, § 46(a)(1).

32 For example, if an individual gets a 10% investment credit for goods purchased before December 31, 1973 and 5% for goods purchased in January of 1974, he should, and probably will, purchase in December of 1973 everything that would be bought in January to June of 1974. Thus, the period of January to June of 1974 would be a colossal bust. The fine tuning idea, i.e., that we needed more investment incentive in 1972-73 than we will need in 1974, was not analyzed in sufficient depth to consider this problem.

33 See text following note 95 infra.

argument, the burden on investment may be viewed as the result of the inherent operation of the mechanisms of our income tax system, which bear heavily on savings,[84] and the unintegrated aspect of our corporate income tax provisions, which bear heavily on the major investment vehicle, the corporation.[85] The argument that the tax system, on balance, overtaxes investment is different in substance from the arguments presented by the Kennedy Administration in support of a similar package in 1961.[86] The difference between the 1961 proposals and the 1971 proposals is that in 1961 a substantial extra depreciation concession was being added to the guideline depreciation.[87] Further, during consideration of the Tax Reform Act of 1969, the Administration recommended to the Senate Finance Committee a two-point reduction in the corporate tax rate.[88] However, this proposal received no attention. As we observed earlier[89] in connection with the relationship between the minimum standard deduction and deduction floors, Congress is concerned about form as well as substance.

If the assumption that the passage of investment incentives was related to the congressional recognition of a heavy corporate tax burden is correct, then the willingness of Congress to enact the investment credit on the basis of less than conclusive evidence is at least partially understandable. It is also interesting that the 20% life-shortening feature of ADR was not so readily accepted. It came within a vote of being eliminated in the Senate. Finally, the view of the congressional decision-making process suggested here correlates with the fact that the incentives enacted give unincorporated businesses a free ride, since such businesses do not pay the corporate tax for which the incentives may be regarded as a "trade-off." Therefore a small-business benefit is quite likely to be attractive to the Congress.

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84 Int. Rev. Code of 1954, § 61(a)(4) includes interest from savings and investments in gross income.

85 For a fuller statement of this position, see 1971 Hearings, supra note 13, at 481.

86 Rev. Proc. 62-21, 1962-3 Cum. Bull. 36.

87 ADR is simply an additive to Guideline Depreciation when one calculates how much rapid depreciation reduces the rate of return impact of income tax. So far as the cash flow impact is concerned, the early effect of the 1961 guidelines was tapering off sharply by 1971. The revenue impact of a depreciation change occurs, however, in the early years. During this time new assets are getting high early year deductions, and old assets, which did not get the high depreciation when they were young, are still getting high depreciation for the late years. Even old assets will have had the new depreciation when they were young, so they will be getting low depreciation in their later years. Some of the cash flow effect of the 1961 guidelines was used up by 1971.

88 Testimony of Treasury Secretary Kennedy, in Hearings on the Tax Reform Act of 1969 Before the Senate Finance Comm., 91st Cong., 1st Sess., pt. 1, at 495 (1969).

89 See text at note 85 infra.

B. *Domestic International Sales Corporation (DISC)*[40]

As investment incentives, the provisions for the domestic international sales corporation (DISC) are of far less quantitative importance than the investment credit and ADR. Basically the new provisions allow a corporation to defer tax on one-fourth of its profits on exports. The mechanics are that a United States parent corporation can sell goods that it produces to a newly organized DISC without regard to the usual rules regarding arm's length prices.[41] One half of the DISC profit is taxable currently to the parent as a deemed distribution,[42] and tax on the other half is deferred until actual distribution, or until sale or exchange of the stock.[43]

Clearly, then, the intent of the statute is to provide tax deferral on what would be, in normal practice, income derived from sources in the United States.[44] The rules for separating the proportion of the total sales price, which is deemed to be earned by the DISC from the proportion deemed to be earned by the parent, are designed to allot as income of the DISC 4% of the total sales price or 50% of the combined profit realized by the manufacturer and the DISC.[45] Since a normal profit to selling-price ratio is about 8%,[46] these two alternative pricing rules have a basic similarity. Whether the taxpayer elects an exemption from a 48% corporate tax on 50% of the income from the sale, or an exemption from a 48% tax on 4% of the total sales price, the result is the same—a tax savings of 1% of the sales price.[47]

A tax savings of 1% of the sales price, if it goes into price reduction, can generate a price reduction of 2%, since price reduction itself further reduces the tax base. Assume that the exporter previously earned 8% of sales before tax and 4% after tax, 100 sales, 92 costs, 4 income tax. If he reduces his price from 100 to 98 his profit before tax becomes 6; his tax prior to DISC benefits would be only 3, and after the DISC benefit it would be only 2; his after tax profit of 4 is restored. Since devaluation reduced United States export prices by 8% in December 1971, and by 10% in February 1973, the value of DISC

[40] Int. Rev. Code of 1954, §§ 992-97.

[41] Int. Rev. Code of 1954, § 994(a).

[42] Int. Rev. Code of 1954, § 995(b)(1)(D).

[43] Int. Rev. Code of 1954, § 995(c).

[44] H.R. Rep. No. 92-533, supra note 16, at 1825, 1831-32.

[45] See Int. Rev. Code of 1954, § 994(a).

[46] 1973 Economic Report of the President 280. The ratio cited there of profit after tax to sales is about 4%.

[47] The long run revenue estimate of DISC is about $300 million, which is about 1% of approximately ¾ of our $40 billion of exports that would qualify for DISC. This calculation provides the same order of magnitude judgment as the provision.

as an export encouragement device has only one-ninth the impact of devaluation.

How much DISC might serve to increase exports would seem to be answered by the answer to the question, "How much would a 2% reduction in U.S. prices increase exports?"[48] However, the Treasury Department made no effort to give Congress any substantive evidence regarding its predictions on how much increased exporting would result for the cost incurred. The leading published work in the field estimated that the price elasticity of exports was approximately 1.5.[49] This means that we could expect a price reduction of 1% to generate a 1½% increase in the physical volume of sales. Since, as we have noted above, the mechanics of the DISC provisions result in a tax savings of 1% of the sales price to the taxpaying corporation and a corresponding revenue loss of 1% to the government, exports that would have cost $100 now cost $99. Taking into consideration a 1.5 elasticity, we can expect this $1 tax savings to encourage sales to increase $100.50. This results in a balance of payments gain of $.50 at the expense of a $1 revenue loss: in short, the DISC is an incredibly inefficient incentive.[50]

Since the Administration had chosen not to present a serious argument based on rational economic and tax analysis in support of the DISC proposal, the legislative history was filled with arguments based on emotion. The most common justification was that "other countries do it": that is, since my neighbor is pushing his products on me—through subsidizing his exports—I shall do the same to him. Acceptance of this rationale meant, in essence, acceptance of the principle that since other countries attempt to encourage exports by an inefficient technique our response should be to use the same technique. The first step in evaluating this response would be a cost-benefit analysis of the effects of imitating the other country. I am sure that the outcome of that analysis would result in the conclusion that this method of export subsidy is an inefficient way to get an offsetting balance of payments advantage. However, the Administration and the Congress voted to imitate foreign

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48 The firm could, of course, do other things rather than decrease prices. It could use the tax saving to spend more money on selling expenses or advertising of its export product. Our assertion comes down to saying that at the margin the exporters should have pushed all sales techniques, price cutting, selling expenses, to the margin of profitability so that at the margin we can use the result of one sale technique, price cutting, as a measure of the effect of any other.

49 Houthakker & Magee, Income and Price Elasticities in World Trade, 51 Rev. of Econ. & Statistics 111 (1969).

50 A previous horror story of inefficient balance of payments policy was a 50% premium under a "Buy America" policy which meant we paid $0.50 extra to save $1.00 in the balance of trade. If the elasticity of demand for exports were —3.0, then an export subsidy would be as inefficient as a 50% premium in a Buy America provision. It is not outlandish that the elasticity might be this high. There have been arguments for values like —4.0. The point is that the Treasury made no effort to back up its recommendation.

DISC-type arrangements without undertaking such a cost-benefit analysis. On the basis of such analysis, however, it must be concluded that more devaluation is clearly superior to export subsidy.

The DISC provisions are an incredibly complex method of providing only a small subsidy. The General Explanation of the Revenue Act of 1971 devotes 24,000 words to the DISC rules.[51] Some of this discourse was occasioned by the need to spell out how the new rules would work in the cases where they appeared to conflict with existing special rules in the tax law. However, other complexities seem to be included for sheer deviltry. For example, to identify DISC profits three alternatives are provided: 4% of sales price, 50% of the profit on the export product or product line, or a third alternative, intended to cover dumping by U.S. firms, in which the export "profits" can be computed without regard to total cost.[52] Congress may have thought that 4% of sales price was too small a base for an export subsidy, but there is no reason to expect that a combination of 4% on some goods and 6% on others would be more effective than 5% on all. The inherent complexity in establishing the cost accounting to provide a larger profit margin on some export goods cannot serve any rational purpose, compared to setting the flat assumption in the first place.

Moreover, there are pages and pages of details describing things that companies can do with DISC profits. Basically the profits must be invested in export related assets, a term which is only loosely defined.[53] Ordinarily this rule will place no constraint on the company. In those situations in which it is a constraint, the investment decision could turn in favor of an export-related asset when the company would really have preferred a domestic asset, but to the extent the investment requirement affects decisions in this manner, the value of the deferral as an initial incentive is reduced. If you cut my tax by $5 provided that I spend $5 on something worth only $4 to me, the net benefit conferred on me is worth only $4, not $5. Therefore, a tax reduction associated with a requirement that proceeds be invested in export related assets would be better structured as a slightly lower tax reduction in the first place without all the administrative technicalities. It staggers the imagination why a simple export subsidy such as DISC had to be surrounded by all this paraphernalia.

Finally, it is interesting to note that DISC was proposed, as most business incentives are, as a measure designed both to change relative costs and to lower corporate taxes. In principle, these two goals could

51 Staff of Joint Comm. on Internal Revenue Taxation, 92d Cong., 1st Sess., General Explanation of the Revenue Act of 1971 (1972) [hereinafter cited as General Explanation].

52 Int. Rev. Code of 1954, § 994(a).

53 Int. Rev. Code of 1954, § 993.

have been separated. It would have been possible to lower the corporate tax rate by an amount which would result in the desired reduction in corporate taxes. It would then be possible to discuss separately the desirability of various measures to penalize domestic business and to subsidize exports. One may speculate whether, had the DISC proposal been presented this way, the legislative outcome would have been different, and which of the two goals would have been found to represent the will of the Congress.

C. *Tax Credit for Employers Under the Work Incentive Program*

One other tax relief measure for business deserves at least brief mention—the tax credit for expenses related to a Work Incentive Program (WIN). In 1967 Congress created the WIN as another of its many work training programs.[54] WIN was directed particularly at welfare recipients, but it enjoyed only modest success. Believing that the problem was too much classroom training and not enough actual job placement, Congress responded in 1971 by enacting a tax credit for WIN employers equal to 20% of wages and salaries paid to WIN employees during the first 12 months of employment, provided that the employment was in a trade or business and provided that it continued for a total of 24 months unless terminated earlier due to voluntary separation or employee misconduct.[55] Acting on the assumption that employment in the private sector was the most desirable means for leading welfare recipients to economic independence, Congress looked upon the job development credit as the only way to bridge the gap between the previous poor record of WIN and its goal of increased employment.[56] But is such a tax credit a viable means for effectuating the intent of Congress?

For a corporation taxable at a 48% rate, the credit reduces the net cost to the employer by 38%, or 19% over two years, which appears to be a powerful incentive. A variety of procedural tests must be complied with: for example, the wages paid must be comparable to those of non-WIN employees,[57] and the WIN employee must not replace another worker.[58] However, the credit is merely a monetary incentive which is not adequately designed to achieve the goals espoused by Congress. There is no reason to expect that 20% is the right incentive in particular cases. Moreover, the only requirement regarding job quality that

[54] Act of Dec. 23, 1967, Pub. L. No. 90-222, tit. I, § 107(d), 81 Stat. 670.

[55] Revenue Act of 1971, § 601(b), amending Int. Rev. Code of 1954, §§ 50A, B.

[56] Senate Finance Comm., The Revenue Act of 1971, S. Rep. No. 92-437, 92d Cong., 1st Sess. 130-31 (1971).

[57] See Int. Rev. Code of 1954, § 50A(d)(1).

[58] See Int. Rev. Code of 1954, § 50B(a)(2).

Congress added to those already in the program was the provision that employment continue for at least two years.[59]

III. The Election Contribution Incentives

The most dramatic innovation in the Revenue Act of 1971 was the introduction of three measures dealing with political campaign contributions.[60] The most spectacular of these was the dollar check-off provision, which permits an individual to designate $1 of his tax liability either for a special account as a campaign fund for a specified party or for a non-partisan general account.[61] Briefly, the system provides that a political party can accept public financing which will entitle it to funds within an upper limit of $.15 multiplied by the U.S. population over 18 years of age and a lower limit of the amount checked off.[62] Acceptance of public financing by the political party involves abandonment of private, traditional financing except for the financing of the difference between the upper limit and lower limit—the amount checked off. Furthermore, acceptance of public financing requires submission to more detailed expenditure controls.

The dollar check-off system became effective with 1972 returns filed in 1973. Response to date has been minimal, due in no small part to the fact that the check-off blocks are not on the face of the return, a circumstance that suggests that the Administration is less than enthusiastic in its support of the idea, although it should be noted that this factor preserves for the taxpayer a measure of privacy regarding his party preferences. (The Administration fought violently and successfully against the application of the dollar check-off system in time for the 1972 presidential election.) The second contribution incentive provides a tax credit equal to ½ of the first $50 of an individual's political contributions.[63] Alternatively, the individual may choose to deduct $100.[64] Political contributions are defined broadly to cover

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[59] Some tax theorists view the WIN credit as inefficient from two viewpoints: first, that the annual revenue loss which it creates is estimated at $30 million, and second, that a large number of employers, such as tax-exempt organizations and businesses which have no taxable income, are prevented from gleaning any benefit from the WIN program. Rather than a tax credit, they suggest a program of direct financial assistance. 1 S. Surrey, W. Warren, P. McDaniel & H. Ault, Federal Income Taxation 466 (1972).

[60] Revenue Act of 1971, §§ 701-03, 802. The tax credit provision is codified in Int. Rev. Code of 1954, § 41; the deduction is codified in Int. Rev. Code of 1954, § 218; the dollar check-off system is codified in Int. Rev. Code of 1954, § 6096.

[61] Int. Rev. Code of 1954, § 6096(a).

[62] Revenue Act of 1971, § 801 (Int. Rev. Code of 1954, § 9004(a)(1)).

[63] Revenue Act of 1971, § 701 limits the maximum allowable credit for a taxable year to $12.50 for an individual and $25 for a couple filing a joint return. Int. Rev. Code of 1954, § 41(b).

[64] Revenue Act of 1971, § 702 (Int. Rev. Code of 1954, § 218). A tax credit allows the taxpayer to subtract the amount of the credit from his tax bill. On the other hand,

payments for both nomination and election campaigns for any federal, state, or local election.[65]

In principle, the handling of election contributions through the tax system appears to rest on a foundation different from that underlying most other tax incentives. There is little doubt that the financing of political campaigns is a national disgrace. Existing laws on control of contributions are quite openly flouted, and many observers are concerned with the fact that access to high office is limited by the need for large sums of money.[66] However, the alternative method of financing elections by government expenditure raises serious doubts about the exercise of controls by whatever political parties are in office. The 1971 Act's dollar check-off system is a variant of this method that seems less susceptible to abuse, since in effect it requires the government to set aside a fixed amount and permits each citizen to decide how his share of this money should be spent. The limitation of this method to income tax returns is a drawback, yet an alternative system that encompasses as many citizens would be difficult to construct. In principle, the check-off could be extended to non-taxable returns, including a very simple return for a citizen who had nothing to report on his tax return except the check-off, thus allowing all citizens, rather than just those with taxable income, to participate in the financing of campaign contributions.[67]

The tax credit of 50% of the campaign contribution of an individual limits the Government's revenue loss to the equivalent of a matching contribution. This result occurs because the government foregoes the collection of tax equal to 50% of the individual's contribution. Thus, if an individual contributes $50, he gets a tax credit of $25; in effect the government is giving $25 to the political party rather than collecting it as income tax. Hence only citizens who care enough to give up $1 to let their candidate have $2 can avail themselves of the benefit of the credit. Inherent in this provision is some discrimination among taxpayers of different income levels, but it seems to be a major step forward from our present system of campaign financing. However, once we understand the mechanics of this credit provision, it will be

a deduction is an allowance against gross income and is subtracted before the tax liability is computed. Therefore the value of a $100 dollar deduction is worth $70 to a taxpayer in the 70% bracket while it is only worth $30 to a taxpayer in the 30% bracket. Thus people will choose the credit when they are below the 25% rate but will choose the deduction when their marginal tax rate is in excess of 25%.

[65] Int. Rev. Code of 1954, § 41(c).

[66] See, e.g., A. Heard, The Costs of Democracy (1960).

[67] It may be possible to argue that a system which restricts the designation of money in the national treasury to those citizens with a specified amount of income is akin to restricting the right to vote to property holders. Such an analogy presents constitutional problems. Permitting individuals who pay no tax to designate $1 for the party of their choice would forestall any constitutional problem.

difficult to justify allowing the deduction[68] as an alternative, since the deduction seems less compatible than the credit with the concept of one-man one-vote.

Basically, voting is regarded as a process different from that of economic consumption where we accept the fact that rich men can buy more than poor men. Taking governmental politics as concerned with the "authoritative allocation of values in society,"[69] we have a body of law built around the concept of one-man one-vote, such as prohibition of the outright buying of votes. In order to carry out the spirit as well as the letter of the law, it is, in my mind, necessary to curtail as much as possible the opportunity open to wealthy interests to buy votes through buying television time and expending huge sums of money on other modes of campaign advertising. However, the function of political campaigns in providing communication between candidates and voters is as necessary as it is expensive, and systems for meeting these costs in ways consistent with one-man one-vote must be developed.

Analyzed in relation to the one-man one-vote concept, a broadened check-off system would provide a system which allows individuals to make contributions at no cost to themselves and involves no disrimination against the poor. Unfortunately this cost-free characteristic has its drawbacks. Costless contributions going to phony candidates could be a source of much abuse. This impracticality of using the check-off system for all campaigns makes its limitation to major presidential candidates understandable.[70] The advantages of cost-free contributions, however, suggest that at least such limited use should be made of a broadened check-off system. Only in this way can extensive contributions from the very poor be expected.

A tax credit device which could allow the taxpayer a credit of 75% instead of 50% also has the potential for preserving the equities of the one-man one-vote system.[71] The fact that there is some cost to the contributor reduces the possibility for abuse and reduces the necessity of structuring rules to limit splinter parties. Thus it would be feasible to allow the credit for all elections which indicates the insufficiency of a check-off limited to presidential elections. The alternative deduction seems to serve no valid purpose that could not be served better by

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68 Int. Rev. Code of 1954, § 218.

69 D. Easton, The Political System 129 (1953).

70 Int. Rev. Code of 1954, § 6096(a).

71 Under this tax credit arrangement the government would pay 75 cents out of each dollar that the individual contributes; thus the cost to the individual would be only 25 cents. The revenue loss to the government in this situation would be greater than under the 50% tax credit now in effect.

making the tax credit limits higher. Thus the tax credit coupled with a check-off seems to be a good solution.

It remains to be seen whether the check-off system will work. Any system of alternative financing of political campaigns will be quite useless if forceful efforts are not made, through additional legislation, to enforce the letter and the spirit of laws limiting large contributions.

IV. THE CHANGES PRINCIPALLY AFFECTING INDIVIDUALS: INCENTIVES AND STRUCTURAL REVISIONS

A. *The Minimum Standard Deduction*

To my mind, the most significant development regarding the taxation of individuals in the 1971 Act was that the Congress chose to add $1.0 billion in tax relief in the form of a $300 increase in the minimum standard deduction.[72] Three conclusions regarding the congressional decision-making process can be derived from this development. In the first place, this action suggests that the Congress is committed to a policy of setting the basic deductions available to everybody at a level approximately equal to the official poverty income levels.[73] This principle was expressed in the reports on the Tax Reform Act of 1969[74] and in the Treasury's Tax Reform Studies and Proposals of 1969.[75] By 1971, however, the minimum income on which single individuals were required to pay tax was, in relative terms, further below the poverty levels than was the income on which large families were taxed.[76] Congress responded to this incongruity by structuring the additional relief on its own initiative.[77]

The relation of the increase in the minimum standard deduction to official poverty income statistics has long-run implications. As money incomes rise, the poverty level will also rise. From 1946 to 1964 this factor was not taken as a serious signal for government action; during

72 The Act increases the low income allowance from $1000 under their existing law to $1050 for 1971 and $1300 for 1972 and all subsequent years. It also raises the percentage standard deduction for those who choose this over the low income allowance—from 13%, with a maximum allowable deduction of $1500, to 15%, with a ceiling of $2000, for 1972 and later years. Revenue Act of 1971, §§ 202-03 (Int. Rev. Code of 1954, § 141).

73 Bureau of the Census, Current Population Reports Series No. 29, Revisions in Poverty Statistics 1959-1968, at 23.

74 See, e.g., S. Rep. No. 91-552, 91st Cong., 1st Sess., reprinted in U.S. Code Cong. & Ad. News 2294 (1969).

75 U.S. Treasury Dep't, Tax Reform Studies and Proposals (House Ways and Means Comm. and Senate Finance Comm., 91st Cong., 1st Sess.) 5 (1969) [hereinafter cited as Tax Studies].

76 See General Explanation, supra note 51, at 51.

77 Secretary Connally's response to this proposal in the hearings was: "We certainly would not recommend it." Hearings on the Revenue Act of 1971 Before the House Ways and Means Comm., 92d Cong., 1st Sess. 102 (1971) [hereinafter cited as 1971 Hearings].

those eighteen years, then, the Government was requiring an increasing number of people who were relatively low on the income scale to pay income tax. This fact partly accounted for the tendency for income tax receipts to grow faster than the GNP. The Kennedy proposal in 1963 for a $300 minimum standard deduction signalled a change in governmental policy. In 1969 the Treasury followed with a similar proposal in the Tax Reform Studies and Proposals[78] which increased the minimum standard deduction by an additional $100. It seems safe to conclude that Congress will attempt to increase the minimum standard deduction at a rate which will keep pace with the rise in the poverty level.

For example, it is reasonable to hypothesize that the Consumer Price Index (CPI) will rise by nearly 7.5% between 1972 and 1974. An increase of $100 in the minimum standard deduction plus $50 in the personal exemption for 1974 would approximately restore the balance obtaining in 1972. In support of this increase in the deduction, it could be argued that the increase would not be a tax reduction but merely a mechanism to offset a reduction in the real value of the basic deductions. A measure that would link these basic deductions—the minimum standard deduction and personal exemption—in an automatic way to the CPI would be an even more sophisticated and effective mechanism. Perhaps the most sophisticated mechanism would be to widen each tax bracket in order to prevent inflation from causing higher rates to apply to lower real incomes and at the same time to increase the basic deductions.[79] However, it would appear that Congress prefers occasional positive action with its attendant political rewards over long-term formula adjustments, and accordingly we should not anticipate the enactment of any of these sophisticated mechanisms.

The second significant aspect of the individual relief provided by the changes in the minimum standard deduction is that it was structured to provide relatively more help for low income individuals. While this direction was indicated by the poverty level statistics the fact remains that the 1971 changes put pressure on the rule that permits some dependents to generate an exemption and deductions on their parents' return as well as to enjoy an exemption and minimum standard deduction on their own returns.[80] To provide a partial solution to this problem, the new Act states that if a taxpayer is a dependent of another taxpayer,

[78] Tax Studies, supra note 75.

[79] For a further discussion of measures of this type, see Tauzi, A Proposal for a Dynamically Self Adjusting Personal Income Tax, 21 Pub. Finance 507 (1966).

[80] An example of this rule in operation can be found in § 151 of the Internal Revenue Code of 1954. According to § 151(e) of the Code, a taxpayer-parent can claim an exemption for a child over the age of 19 who is a student, provided the parent pays for over one half of the child's support. Under § 151(b), the child, who may also be a taxpayer, may claim an exemption for himself on his own tax return.

then he may not use the standard deduction to offset investment income, which the statute calls "unearned income."[81] The Congressional acceptance of the Marxian notion that investment income is unearned is curious. This provision, however, does not disguise the fact that there is practically no equitable justification for permitting even two exemptions for some favored dependents, and that allowing any additional standard deduction adds to the inequity.[82] The device Congress uses to mitigate these inequitable results is the principal support test, which will usually eliminate multiple exemptions in situations where the "dependent" has a substantial amount of income, unless the family income is large.

Ostensibly Congress has tolerated this very favorable treatment for certain dependents because it provides an incentive for student earners.[83] Given the congressional concern for extending coverage of the minimum wage, which tends to reduce teenage employment,[84] the congressional enthusiasm for this incentive is mildly puzzling. It is characteristic here, as in most other congressional forays into the field of incentives, that the record shows no evidence of hard analysis of costs and benefits. I offer the purely personal prediction that the Congress will get around to looking more closely at this problem of excessive non-taxability of dependents.

A final noteworthy factor in the 1971 Act's provision of income tax relief for individuals is that Congress used the increased minimum standard deduction as the vehicle for providing that relief. A minimum standard deduction can be described in two ways that are identical in their effects:

> (1) a minimum standard deduction of $1,300 in lieu of the 15% standard deduction or in lieu of itemized deductions; or
>
> (2) a revision of the per capita exemption system into a system of a $2,050 exemption for the first exemption of each

[81] Revenue Act of 1971, § 301(a) provides that for one who is a dependent of another because he is a child of that other and under 18 years of age, or has a gross income under $650 a year, or is a student, the percentage standard deduction which he can claim on his own tax return "shall be computed only with reference to so much of his adjusted gross income as is attributable to his earned income" and his "low income allowance shall not exceed his earned income for the taxable year." Int. Rev. Code of 1954, § 141.

[82] See Seltzer, The Place of the Personal Exemptions in the Present-Day Income Tax, in 1 House Ways and Means Comm., Tax Provision Compendium 493 (1969). See also H. Groves, Federal Tax Treatment of the Family 40-43, 100-01 (1963). I would regard a small exclusion for income from personal effort of dependents as warranted on grounds of administrative simplification, although basically inequitable.

[83] See H. Groves, supra note 82.

[84] Moore, The Effect of Minimum Wages on Teenage Unemployment Rates, 79 J. of Pol. Econ. 897, 902 (1971).

return, plus $750 for each additional exemption, plus a rule that disallows the first $1,300 of itemized deductions or of standard deduction.

Basically, of course, providing a standard deduction is like disallowing some deductions. Apparently recalling the strong opposition to placing a floor under itemized deductions, as proposed by President Kennedy in 1963, Congress now proceeds indirectly toward providing such a floor. Giving some deductions to everybody is like building them into the rate system. It is then only actual deductions over the amount of the standard deduction that makes a difference in one's tax. This point, too, has some relevance to our examinations of congressional thinking on incentives. In the rather narrow area covered by the standard deduction, Congress is willing to sacrifice some of the present incentives for contributions, home ownership, and the like, in order to achieve greater equity in the tax system.[85]

B. *Increased Withholding*

The change in income tax withholding on salaries and wages enacted in 1971 became, briefly, a cause celebre in 1972. A comment on the change is worthwhile, even though the topic does not precisely fit our theme of incentives, since the present author was personally responsible for some of the mechanics as well as for some of the wrong revenue estimates. This article thus offers an opportunity for public confession.

The mechanics are unimportant. The substance of the problem was that in 1970-71 there was much concern about *under*-withholding,[86] and this problem would have been aggravated by the 1971 changes in the standard deduction. The response recommended by the Administration, and taken by the Congress, increased the formal withholding[87] and at the same time increased the opportunities for individuals to reduce the formal withholding as appropriate to their circumstances.[88] Theoreti-

[85] For a further comment along this line, see Surrey & Brannon. Simplification and Equity as Goals of Tax Policy. 9 Wm. & Mary L. Rev. 915 (1968).

[86] 1971 Hearings, supra note 77, at 100, 118.

[87] Revenue Act of 1971, §§ 208(a), (b). The Act increases the rates at which taxes are withheld and decreases the lowest bracket—from $1050 on an annual basis to $550—for which withholding is made applicable. As a result the full amount of tax liability is now being withheld for a single person up to a wage level of approximately $25,000 and for a married couple with only one spouse working up to a wage level of about $31,000. Int. Rev. Code of 1954, § 3402.

[88] Revenue Act of 1971, §§ 208(c), (e), (f). Section 208(c) provides that a single person with only one employer or a married person, if his or her spouse is not employed, may have the full $1300 low income allowance taken into account for withholding purposes by claiming a "standard deduction allowance" on his or her withholding certificate (Form W-4). This insures that for qualified individuals income will not be subject to

cally, these changes could, on balance, have reduced withholding. The Treasury correctly estimated that most of the opportunities for individuals to reduce withholding would not be used: rather, that only about a quarter of the potential would be used. In fact, this prognosis turned out to be an overestimate, a development that may have been due in part to the late passage of the Act—December 11, 1971—which made it difficult to mount a public education campaign regarding the changes effective for 1971. The lesson to be learned from this withholding issue is that most individuals appeared to prefer over-withholding and its characteristic of forced savings. If this is in fact true, the continued absence of a withholding tax on dividends and interest seems indefensible from a tax equity standpoint. Such withholding was rejected by the Congress in the past due partly to a concern that the overwithholding which would occur in some cases would hurt people. Apparently it does not.

C. *Child Care Allowances*

Since the matter of child care allowances is analyzed more extensively in this issue in the article by Professor Klein, little will be said here beyond commenting on the incentive and phase-out of aspects of the child care allowance provided in the 1971 Act.

Congress expanded the rather minimal child care allowance then in effect into a more generous allowance for child care and housekeeping costs for households which contained a qualified dependent, and where both parents were employed.[89] The committee report specifically referred to extending the deduction to cover the costs of house care and took credit for providing an incentive to hire domestic help.[90] The provision was enacted during the congressional battle over the relative merits of encouraging increased work on the part of the poor as opposed to providing relief through welfare payments; yet it does not appear that Congress attempted a serious analysis of the child care provision as an incentive device.

Another characteristic of the child care deduction that merits comment is that the deduction begins to be phased out in all cases where the combined income is over $18,000 and is entirely denied to families with

withholding below $1300 instead of the regular low bracket level of $550. Section 208(e) provides that a taxpayer with a large amount of itemized deductions may claim an additional withholding allowance for each $750 of itemized deductions in excess of 15% of estimated wages or $2000, whichever is less. And § 208(f) provides that the additional allowances claimed are to remain in effect until the taxpayer files a new withholding exemption certificate with his employer because of a change in circumstances, as required by law. These provisions apply to wages withheld after January 15, 1972. Int. Rev. Code of 1954, § 3402.

89 Revenue Act of 1971, § 210, amending Int. Rev. Code of 1954, § 214.

90 See General Explanation, supra note 51, at 5.

incomes over $27,600. The significance of and rationale behind this phase-out mechanism are unclear. One may characterize child care and household expenses as costs incurred in the production of income by one of the two working spouses. Given the split income provision of the federal income tax, the absence of a deduction for such costs, together with the absence of any imputation of income for either spouse's services in the home, results in two families with the same total income —one with only a single wage earner and the other with two wage earners—being taxed the same despite differing abilities to pay tax. This differing ability occurs because the family with two wage earners must hire someone to do the household chores with after-tax dollars while in the family where one spouse stays home these services are performed free of tax. In addition, in the family in which both spouses work, the income of one is taxed at the other's marginal rate. The phase-out, then, appears unjustified.

The thrust of this argument is that recognizing some deduction for working wives is fair at any income level. But why stop the deduction at higher incomes? One possible reason would be a judgment that the phase-out is justified because high income families would incur costs for child care and household care even if only one spouse was working and the other stayed at home: in such situations, then, these expenses should not be regarded as business costs, since they are not incurred to enable the taxpayer to secure employment. I find this argument unrealistic. I doubt that many families with $25,000 of income have school-age children in special facilities during non-school hours, and I also doubt that they have full-time maids unless both parents work. In any case, this attitude that "he would have spent the money anyway" is not used in the tax law to disallow such business expenses as the cost of meals purchased during travel or the cost of one's own meal in an entertainment lunch, and should not be used with regard to the child care deduction.

If these child care costs are analogous to business expenses, the allowance of the deduction with the phase-out mechanism may be viewed as the equivalent of an unrestricted allowance of the deduction, coupled with an additional income tax on those with incomes over $18,000, to offset the deduction. Since we have one income tax already, the need for another is curious. If Congress thinks that (1) item x should be deductible, but (2) deduction of x would reduce average taxes too much in the upper brackets, then a simple solution would be to allow everyone to deduct x and to adjust surtax rates so as to produce the appropriate net tax in the upper brackets. The alternative solution, enacting an x deduction with a phase-out, is essentially irrational. If x is related to the ability to pay, then a family with income above the phase-out limit with x expenses should pay a lower tax than another family above the phase-out limit who do not have x expenses and whose circumstances are otherwise identical. "Phasing-out" the x deduction prevents the deduction from accomplishing its tax relief objectives and serves only to complicate the tax law. Yet the phase-out mechanism is accepted in the political process, presumably because legislators are averse to changing tax rates. It is becoming increasingly popular to propose new special deductions with phase-outs, but proponents fail to consider the fact that complication of the tax law has a marginal cost greater than zero. If the deduction for child care expenses is to be allowed at all, it should be an across-the-board deduction, uncomplicated by this cumbersome phase-out mechanism. The treatment of the child care deduction provides us with a good example of the phenomenon that tax policy makers do not believe their own speeches about tax simplification.

D. *The Automobile Excise Tax Reduction*[91]

In early 1971, we have two large excise taxes, one on telephone service and one on automobile sales, which, on the legislative record, did not reflect a social cost but were for revenue purposes only. Both were scheduled to be phased out by 1980.[92] Presumably the Administration's fiscal judgment was that we could afford an immediate repeal of only one of these excise taxes, and the Administration chose the automobile tax. There was apparently no sophisticated analysis or explanation by Congress of the rationale behind this choice. The theory that the elasticity of demand for automobiles is higher than it is for telephone services[93] does not provide any insight into the congressional decision-making process. Even if a lower price for telephone service would result in no more use of telephone services, then all our economic evidence would suggest that money saved by paying less for telephone service would be spent on other things.

However, the possibility that cutting automobile taxes would result in more automobile sales has strong political appeal, because the automobile case would have a more immediately concerned and vocal public, and that fact would have obvious consequences for the political decision-making process. On the other hand, cutting telephone taxes

[91] Revenue Act of 1971, § 401(a) provides for the repeal of the 7% excise tax on passenger automobiles and the 10% excise tax on light duty trucks having a gross vehicle weight of 10,000 pounds or less.

[92] Under prior law a 10% excise tax was levied on trucks, buses and certain types of tractors, the rate to be reduced to 5% on and after October 1, 1977. A 7% excise tax was imposed on automobiles, the rate to decrease gradually to 1% by 1981.

[93] H. Houthakker & L. Taylor, Consumer Demand in the U.S. (2d ed. 1966) puts both price elasticities at zero. Other analyses have put the auto price elasticity higher. Suits, The Demand for New Automobiles in the U.S., 1929-56, 40 Rev. of Econ. Statistics 277 (1958).

would increase consumer expenditures in general—a result which does not have strong political appeal.[94] Yet there is increasing talk of the social cost of the automobile: since automobile users impose costs on the rest of society, then, other things being constant, it seems fair to conclude that people are spending too much on automobiles.[95] The decision to purchase an automobile could be discouraged by an automobile tax. On these grounds, then, it would not have been ridiculous to have favored the telephone tax cut over an auto tax cut; yet once the Administration spoke, there was virtually no legislative activity favoring retaining the auto tax and reducing the telephone tax. Some activity mildly favored a telephone tax reduction in addition to the automobile excise tax reduction, but the general congressional discipline regarding limiting revenue losses made it easy for the bill managers to thwart this attempt.

Conclusion

Does the Revenue Act of 1971 signal the end of tax reform and the return to a system of using the tax law to provide incentives for behavior that the government wishes to stimulate or thinks advantageous? Since the question involves future action, no definite answer is possible. Nevertheless, I offer a tentative "No."

The major incentive, the investment tax credit,[96] may be characterized as an effort to deal with what is seen as a fundamental problem, real or imagined, in the tax system—the over-taxation of capital. There are good reasons supporting the conclusion that capital is, in fact, taxed too heavily under the present system; but whether or not one agrees with this conclusion, it is submitted that the policy makers believe that they are dealing with the problem of the over-taxation of capital. Instead of providing investment incentives, a more viable solution to the problem would be to integrate the corporate and individual income tax provisions. In addition, perhaps we should debate more openly whether or not there is in fact an over-taxation of capital.

The issue in these matters is different from the issue involved in the more gimmicky tax devices designed to change the relative costs of

94 The reason for this lack of political appeal is found in dynamics or our legislative process. Since an automobile tax cut would result in more money being spent on automobiles, the auto industry will lobby the bill. A telephone tax cut would result in more spending but spread throughout the economy. Thus, no one group would have enough of an interest to lobby.

95 For a detailed discussion of the issue of the social cost of automobiles, see E. Mishan, Costs of Economic Growth (1967), and 1971 Hearings, supra note 77, at 1200-03, 1221.

96 Int. Rev. Code of 1954, §§ 46-48. See discussion in text at notes 21-39 supra.

extracting natural resources,[97] investing in municipals,[98] owning one's own home,[99] and the like.[100] The incentives for exporting and for hiring WIN employees can definitely be classed as gimmicks and are not as easily dismissed as evidence of congressional disinterest in tax reform as the broad investment incentives. I am inclined, however, to attribute the enactment of each of these provisions to the peculiar circumstances existent at the time of their enactment, and we hardly need accept them as permanent. For example, most economists react to the machinations of governments to preserve the balance of payments in a regime of fixed exchange rates with the sort of pity that one feels for a retarded child.[101] Fortunately, the child is showing signs of growing up, and we seem to be on the way to exchange rate flexibility in which the market will control the flow of exports. In such a system, a program like DISC is ultimately doomed, along with other irrational trade interferences.

The WIN provisions were developed out of the excitement of the workfare-welfare argument and were presented as an alternative by the concurrence of forces that aborted a promising start on a system of income conditioned cash transfers, frequently called a negative income tax. By late 1971, it was clear that the president's venture toward a negative income tax—the Family Assistance Plan—would not pass the Senate. It was also clear that the work incentives in traditional welfare systems were miniscule. Understandably, other solutions were groped for and the choice fell with the WIN provisions. However, I am convinced that the negative income tax can provide a rational solution to the work problem, since the essence of the negative income tax is to moderate the loss of welfare payments involved in a welfare client taking a job.

The political contribution incentives are significant because they involve, in a unique way, the business of government, and a tax return is not an inappropriate place for conducting government-citizen business.

Despite its general tenor there were some small signs of the "spirit of '69" in the 1971 Revenue Act. Notably, three five-year amortization provisions for certain railroad rolling stock, for pollution equipment and for mine safety equipment,[102] which were enacted in 1969 as substitutes for the old investment tax credit, were made largely nugatory by

[97] Int. Rev. Code of 1954, §§ 611-32.

[98] Int. Rev. Code of 1954, § 103.

[99] Int. Rev. Code of 1954, § 163.

[100] ADR falls, I think, between the gimmicks and the investment credit. The credit at 7% is smaller than the extra burden of the corporate tax, so one could argue for extra balance. Achieving this through distorting a proper business deduction is gimmicky.

[101] D. Easton, supra note 69.

[102] See Int. Rev. Code of 1954, §§ 169, 184, 187.

a decision to deny the investment tax credit to investments taking the five-year amortization.[103] In addition, the extension of the minimum standard deduction was also a reform measure.

The Revenue Act of 1971 makes it clear that the Congress and the Treasury, in their efforts to create specific incentives, made no serious effort to justify such incentives as DISC and ADR on the basis of hard cost-benefit analysis. Rather, these measures give every indication of being haphazard gimmicks designed to deal with imagined problems, and moreover of being heavily influenced by the contentions of their direct beneficiaries that what is good for them is good for the United States. Nevertheless, I offer my unsubstantiated optimism that, with the developing sciences of public policy analysis and such adjuncts as cost-benefit analysis, the kind of amateur dirigisme involved in most of our tax incentives will fade.

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103 Int. Rev. Code of 1954, § 48(a)(8).